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SUBJECT: South China Rule of Law Retreating in the Face of Economic Downturn

REF: A) 2008 GUANGZHOU 618; B) 2008 GUANGZHOU 732; C) 2008 GUANGZHOU 704

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11. (SBU) Summary: Is the rule of law yet another casualty of the economic downturn in south China? That's what international firms and other concerned observers are afraid of, and the signs are pointing somewhat ominously in the direction of turning back the clock. A large multinational toy firm was told to overpay for its own assets that were seized after its supplier's bankruptcy in October, 2008 - extorted as it were. The western company was told that if it didn't follow instructions, the assets, including proprietary tooling and other intellectual property, would be sold at local auction to the highest bidder. International business and law contacts separately report that Chinese judges and arbitrators are explicitly warning plaintiffs that enforcement of legal judgments in business disputes may not meet their expectations in cases that would destabilize defendant companies and their local employees. Separately, local media reports announced that the Guangdong Communist Party's (CPC) Disciplinary Inspection Committee and the Guangdong Procuratorate have each announced measures to ease law enforcement efforts in cases where punishment might impact the ability of a major firm to maintain economic growth. Internet chat rooms are buzzing with questions about what it all means and decrying the retreat from rule of law advances of recent years. End

summary.

Possession Is Still the Law

¶2. (SBU) Local government actions cleaning up after factory closures in Guangdong have raised critical questions about rule of law for international business people in south China. In the case of Smart Union, the toy manufacturer whose closure made headlines when workers demanded back pay, some major western customers took precautions to remove proprietary tooling and other products before the factory closed on October 15 (ref A), but others were not so lucky. One such company is now facing escalating local government demands that the major western toy company buy back its own proprietary tooling, contracted materials and products that Smart Union had been manufacturing when the Hong Kong-invested firm shut down. In addition, the price quoted by the local government in this case is double what the western firm says they're worth, and resolution of the case has been delayed multiple times as the government has added new requirements and fees each time it appeared that a settlement was near.

¶3. (SBU) Local corporate counsel for the western toy company called the local government's actions "an extortion," and has devoted much of the last three months to resolving this case. The lawyer said local government officials see his company's seized assets as an opportunity to recoup some of the RMB 24 million (USD 3.5 million) in back pay that the local government was forced to pay Smart Union workers. The western firm has met and corresponded with local

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officials representing the township government, Communist Party leadership and the courts, in addition to lobbying the central government's Ministry of Commerce and other higher-level officials at the municipal and provincial governments, but to no avail. Although the western company has had success in negotiating a lower price for the assets, the local government has repeatedly imposed new requirements like monthly storage fees at twice the market price and other onerous requirements related to temporary storage of the western company's assets. At each stage of negotiations, local government officials reiterate that noncompliance will result in the western company's "unclaimed" property being sold at auction to the highest bidder, which would violate local law and existing contracts, including China's laws and regulations protecting intellectual property, according to the western firm's lawyer. (Note: we expect more cases like this in the future. In some instances, local governments will seek funds from western companies up front in the event that they go out of business; that way, the governments will have funds in reserve to cover costs to pay off workers. It remains an open question whether the governments will in fact keep these monies in reserve or use them for other purposes. End Note.)

Enforcement Judgments Hampered

¶4. (SBU) Other business and legal contacts have also reported that legal resolution of commercial disputes, especially intellectual property rights (IPR) civil cases, has measurably weakened as court officials express doubts about enforcing judgments that might cause defendant companies to go out of business or shed local workers. Corporate counsel for a well-known U.S. technology firm recently told econoff that despite submitting a binding arbitration judgment to a Shenzhen court for enforcement against a local Chinese company that was found to violate the U.S. firm's IPR, the court repeatedly delayed or avoided taking action in the case. Although persistent efforts by the U.S. firm eventually secured the desired outcome, the judge in the case initially told plaintiff lawyers that it was unreasonable to expect enforcement of the arbitration decision if it meant the defendant company's workers would face unemployment.

¶5. (U) The U.S. company's experience might represent a broader trend in IPR enforcement, in which Chinese media reported December and January announcements by Supreme People's Court (SPC) Third Division Court Vice President Kong Xiangjun that the SPC is studying "new adjustments" to its IP policy to help domestic companies "survive"

the current economic crisis. Kong suggested that rather than insisting on immediate cessation of IP infringement, a new "public interest" test may be introduced to determine whether cessation would "violate public interest." Such a decision would potentially mean that the normal "cease and desist" orders might be forgone in favor of monetary fines, even as the infringing behavior would be allowed to continue uninterrupted. One major news outlet also reported that the SPC has already distributed the new guidelines internally even as the policy deliberations continue.

All in the Name of "Safeguarding Economic Growth"

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16. (SBU) Guangdong officials have publicly announced their own plans to loosen law enforcement efforts in cases that might jeopardize growth and jobs. The Guangdong Province Communist Party Disciplinary Committee issued guidance at the beginning of January calling for cautious consideration of affected companies' stability when handling disciplinary cases related to senior management of state-owned enterprises (SOEs) and publicly-listed companies. The Guangdong Procuratorate went even further, issuing ten measures to help local enterprises facing economic difficulties, including a measure to postpone actions against company management committing "small crimes." (Note: Please see paragraph 10 for a complete list of the ten measures. End note.) A spokesperson for the Guangdong Procuratorate told reporters that an example of the new policy might involve a company executive who was caught accepting bribes of RMB 110,000 (USD 16,000), but was not detained by authorities because he was in the middle of negotiating an important deal with a Japanese company. The spokesperson said that if the suspect was the only person able to answer the Japanese company's technical questions, the Procuratorate would delay arresting him in the interests of the company's growth and stability, and to insure success of the deal. (Comment: This example could just as easily involve negotiations with a U.S. company. The scenario inevitably leads to the foreign company unwittingly making a deal with a Chinese partner who has serious legal liabilities. End comment.)

17. (SBU) The same press report goes on to announce that prosecutors at all levels of government in Guangdong Province have received official instructions to apply the principles of economic growth and stability in all cases involving corporate managers and other technical staff to avoid arrests and detentions that would negatively impact overall company stability and normal operations. The guidelines give flexibility to prosecutors to decide not to detain or arrest individuals involved in a host of crimes, including giving or accepting bribes and private use of SOE resources.

Netizens Question the Effects of Leniency

18. (SBU) Internet chat rooms erupted with questions and comments about "discounted rule of law" shortly after the Guangdong government announced its measures to safeguard economic growth. One posting declared that the measures were tailored to favor SOE senior management and likened the new policies to the "feudalist tradition" of "the ministers may not be punished." Another asked where the line would be drawn between "normal crimes" and felonies, pointing out that rule of law efforts would be in vain if the principles could be pushed aside whenever a "special situation" occurred. One chat room comment suggested that many SOEs would be saved or be better off if their top managers were arrested. (Note: Consulate Guangzhou first reported these developments in its blog, South China SEZ: http://www.intelink.gov/communities/state/southchinasez/archives/on_line_buzz_1519.html . End note.)

Comment: Real World Get Out of Jail Free Card?

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19. (SBU) The subjective standards being introduced by provincial and

local authorities to "help" companies weather the global financial crisis have turned back the clock on some of the important achievements of China's reform and opening and introduce structural problems into the economic and legal systems that will be hard to repair when the economy eventually recovers. The fact that government officials are determined to ignore these possible consequences even as netizens and foreign business leaders sound the alarm indicates how seriously troubled China's leadership is with the potential threat to social stability posed by the economic downturn.

¶10. (U) The ten measures announced by the Guangdong Procuratorate are:

- Guangdong Procuratorate must play its role in enterprise development to guarantee steady and relatively fast economic growth
- Carefully handle cases with small and medium enterprises (SMEs) and cases of corporate graft to balance law enforcement with enterprise survival and development, workers' livelihood and social stability
- Improve work processes by carefully investigating reports and tips of enterprise irregularities to balance law enforcement with enterprise survival and development
- Intensify law enforcement efforts in areas that harm businesses such as money laundering and counterfeiting, white collar crimes related to financial products and real estate, and IPR enforcement to promote enterprise innovation
- Crack down on bribery and embezzlement among public servants and SOE employees
- Be proactive in preventing bribery and embezzlement cases, especially among large infrastructure projects
- Strengthen the supervision of case filing for economic crimes, especially when enterprises are involved
- Try to be flexible when applying the law on economic crimes; try to balance the normal operations of the enterprise and the legal rights of the public
- Use comprehensive methods to solve conflicts caused by the economic crisis
- Improve service to enterprises by improving the handling of economic crimes involving enterprises, the reporting and coordinating system of economic crimes, communications with PSB and courts, contacts with enterprises, and familiarity with problems that affect economic development and arouse dissatisfaction of the public.

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